MSRB
Municipal Securities Rulemaking Board

Remarks of Lynnette Kelly, Executive Director

at the

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INTRODUCTION

Thank you for inviting me to join you here today. I have the challenge of talking about the U.S. municipal bond market, recent developments, and lessons learned as other countries seek to learn from our successes and our mistakes. And yes, I need to do all of this in 12 minutes.

Let me start with a question.

Why does confidence in the U.S. municipal market remain so strong in the wake of the 2008 financial crisis, high profile bond defaults, and the daily headlines on the precarious fiscal health of some of our state and local governments?

We know that confidence doesn't make markets rise and it doesn't make markets fall. Confidence makes markets possible. It's the underlying reason why the U.S. municipal bond market is as strong as it is today.

Transparency, disclosure and accountability aren't just catchwords. They are essential ingredients to confidence. And without them, markets can't remain healthy, grow or adapt to a changing environment.

U.S. INFRASTRUCTURE

Let me begin with some context. Fully 2/3 of infrastructure in the United States is funded by municipal bonds. There are over 50,000 state and local governments that have authority to issue bonds and there are over $3.7 trillion in municipal bonds outstanding, much of which is owned by retail investors. It goes without saying then, that this market is essential to the health, safety and economic well-being of each and every citizen.

Many papers have been written and speeches given about the necessary attributes of a well-functioning municipal bond market. And clearly given the attendance at this event, accelerating the development of local municipal bond market continues to be an area of interest for mature as well as for emerging economies.

So what market attributes are necessary to attract both issuers and investors and give them the confidence to participate in this marketplace?

DEMAND SIDE

On the DEMAND side, Investors typically require:

- Well-established legal and market structures.
- Investors demand the ability to trade their bonds. (The importance of policies that promote liquidity cannot be overstated.)
- Investors want the freedom to invest wherever they see a good opportunity. (The U.S. has no restrictive government controls on investment opportunities or choices. In general, our policies promote a diverse investor base.)
- Investors demand acceptable investment returns and want to be compensated for the risk they assume.
- Investors demand – and deserve – complete and accurate information regarding the issuer, the security and the risks. (The U.S. has standardized legal disclosures, and agreed-upon standards of accounting, auditing and financial reporting.)
- And finally, investors – especially retail investors – need assistance in interpreting information. (Our municipal bond market relies heavily on independent rating agencies, bond insurers, independent analysts, bond funds, and other market intermediaries.)

SUPPLY SIDE

On the SUPPLY side, accessing the municipal bond market must be an attractive option to issuers.

Issuers typically require:

- Tolerable borrowing costs. (In the U.S., the tax exempt status of most municipal bonds results in a lower cost of capital for state and local governments; a large number and variety of investors competing for good bonds; and competition amongst underwriters keeps borrowing costs low.)
- Flexibility. Generally, municipal bonds have a stronger credit quality, also resulting in lower costs of capital for the issuer. (The U.S. municipal market has different credit profiles dependent on the type of issuer and the source of repayment of the debt: general obligation tax supported debt; revenue debt secured by receipts from the enterprise; and the existence of separate agencies and authorities with borrowing powers which limits the exposure of the municipality.)
- Issuers need long-term debt amortization to match debt service with the life span of the infrastructure assets being built, thus reducing the size of annual debt service payments.

(In the U.S., maturities can go out as much as 30 years, although we have seen maturities as long as 50 years or more on occasion.)

- Assistance for small borrowers. (In the US, we have over 50,000 municipal issuers, the vast majority are small and less sophisticated, coming to market very infrequently. We have established bond banks, revolving fund structures, pooled structures and other vehicles to allow small issuers to access the national capital markets at an affordable cost.)
- Appropriate regulation (In the U.S., state and local governments have the freedom to borrow without seeking approval of the federal government. The focus of regulation has been on disclosure, rather than making a judgment on credit quality of a particular issuer or type of security.)

ESSENTIAL MARKET CHARACTERICS

So we know what investors and issuers need to have confidence and what to expect from a well-functioning municipal bond market.

What are the other characteristics that policymakers, academics and other market participants have identified as essential market characteristics?

These additional characteristics include:

- Rational macro-economic, fiscal and monetary policies to keep inflation in check; and provide stable and prudent growth.
- Sound legal and banking institutions, and strong legal and regulatory frameworks for certainty and predictability. This includes standard default procedures for orderly resolution/bankruptcy with creditor rights and clarity over seniority of their claims.
- Robust disclosure requirements for issuers.
- Availability of credit enhancement vehicles (bond insurance; guarantees; securitization).
- Established benchmarks to insure validity of pricing.
- Credible accounting systems and independent audits.
- Strong bond covenants to clearly signal credit risk.

- Independent third party credit ratings.
- Secure clearance and settlement procedures.
- Predictable fiscal relations with the central government.
- Transparent municipal budgets, including financing transparency – how much is being borrowed; how it is being paid back; what is being financed.
- An efficient and effective municipal service delivery system with rational pricing and performance delivery metrics.

Taken together, these attributes help build and sustain the confidence necessary for healthy markets.

DEVELOPMENTS IN THE U.S. MUNICIPAL MARKET

Let me turn now to developments in the U.S. municipal bond market.

Technology has been the single biggest driver in the transformation of the U.S. municipal bond market.

The market has been transformed from an opaque, over the counter market where the information advantage has clearly been in favor of market professionals to one where disclosure and pricing information is made available to all stakeholders at the same time.

Electronic trading systems have essentially supplanted the voice broker and has made trading more open and efficient.

There is a wealth of post-trade data and a focus on making pre-trade information more readily available in real time to help with pricing and understanding depth of market.

The MSRB developed and runs the Electronic Municipal Market Access website – EMMA for short – which provides market participants with a wealth of information.

- First, primary market and ongoing disclosures throughout the life of the bond are posted to the EMMA website.
- Second, information for nearly all trades of municipal bonds must be sent to the MSRB within 15 minutes of the trade, and immediately posted to the EMMA website.
- Interest rate resets and letter of credit documents are posted to EMMA for short-term debt instruments.

- Market data and statistics are provided on EMMA real time, as are credit ratings for each security.
- A number of tools have been developed for retail investors to help them access and understand the information.
- Tools for issuers are also being developed to assist with market access, new issue pricing and to allow them to be more active participants in the issuance process with the professionals they employ.
- It is important to note that access to the EMMA website is free of charge, and that the site democratizes the access to information whether you are a market professional or a retail investor.

CHALLENGES IN THE U.S. MUNICIPAL BOND MARKET AND HOW TO ADDRESS THEM

- So I don't want to leave you with a sense that all is good in the U.S. municipal bond market.
- We certainly have our challenges.
- Financial discipline of issuers - Issuers may not have prudent debt management policies in place; they may make poor decisions; state oversight may be required.
- Sophistication of small or less frequent issuers – role of regulated financial professionals upon whom they rely is paramount, as is the ability of small issuers to use bond banks or other types of pooled financings.
- Political will to make tough decisions; tension between political influence and public policy (Reliance on one shots; kicking the can down the road) – We see that playing out right now in the City of Chicago and the State of Illinois.
- Uncertainty over creditor rights and seniority of claims – the issue is who do you pay when resources are limited: city workers/pensioners or debt holders (can become an issue of Main Street versus Wall Street) – Detroit is the prime example where bondholders were disadvantaged vis a vis city workers.
- Sales of certain securities not meant for retail to retail customers – As Puerto Rico became less and less able to meet their obligations, their debt was targeted for institutional investors only under the theory that they better understood the risks. Despite this, some dealers sold such bonds to retail investors.

- Failure to disclose material events – There are examples where issuers have not been forthcoming in making all appropriate and required disclosures to the market.
- We continue to see excessive mark-ups on bonds sold to retail customers and have rigorous enforcement tools available to catch these violations.
- There is a concern that over-regulation has caused dealers to exit the market or devote substantially less capital to providing liquidity.
- And finally, we have to be ok with letting issuers and investors make bad decisions – and suffer the consequences of those bad decisions. We are seeing a lack of accountability and responsibility in the market where people seem to be looking for someone else to blame when things don't go according to plan.

LESSONS THAT ASIA CAN LEARN FROM THE MATURED U.S. MUNI MARKET

So I've given you a lot to think about. There are basic market fundamentals which need to be present in order to build the confidence necessary for healthy and sustainable markets.

And transparency, disclosure and accountability need to be the guiding principles to inform your work day in and day out.

So think about:

- Promoting liquidity in every way possible.
- Utilizing credit support products that promote attractiveness of bonds (insurance; credit ratings, guarantees)
- Providing comprehensive, accurate and timely disclosures and tools for investor due diligence.
- Removing the influence of politics from the issuance process (Pay to play rules; ballot elections; debt restrictions)
- Harnessing technology (centralized system; access to information; communication tool for issuers to speak to the market)